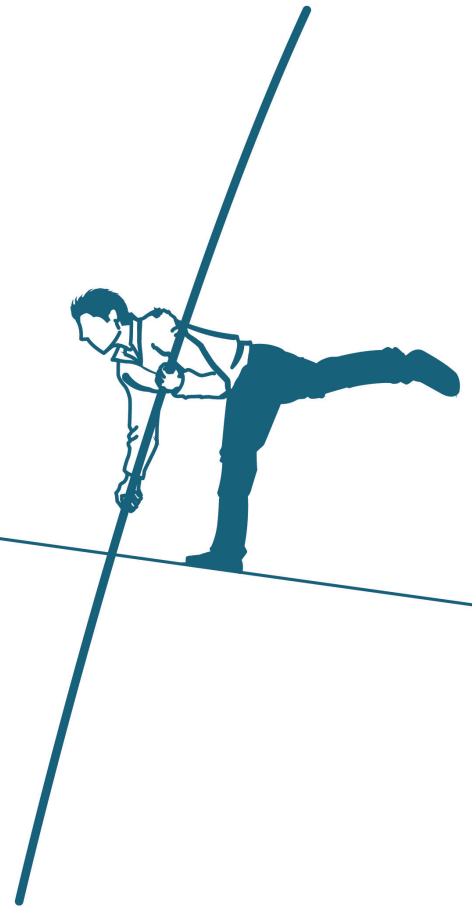


ACHIEVING THE RIGHT BALANCE

CalPERS Board Governance Study
Final Report
September 2011



CalPERS Board Governance Project – Summary Results

The California Public Employees' Retirement System (CalPERS) is the nation's largest public pension fund with total net assets of \$237.5 billion as of June 30, 2011. Headquartered in Sacramento, CalPERS provides retirement and health benefit services to more than 1.6 million people and 3,033 school and public employers. The CalPERS System also operates eight Regional Offices located in Fresno, Glendale, Orange County, Sacramento, San Diego, San Bernardino, San Jose, and Walnut Creek.

Led by a 13-member Board of Administration, consisting of member-elected, appointed, and ex officio members, CalPERS membership consists of 1,116,044 active and inactive members and 513,623 retirees, beneficiaries, and survivors from State, school, and public agencies.

Established by legislation in 1931, the System became operational in 1932 for the purpose of providing a secure retirement to State employees. In 1939, new legislation allowed public agency and classified school employees to join the System for retirement benefits. CalPERS began administering health benefits for State employees in 1962, and five years later, public agencies joined the Health Program on a contract basis.

As a defined benefit retirement plan, CalPERS provides benefits based on a member's years of service, age, and highest compensation. In addition, benefits are provided for disability and death. Today CalPERS offers additional programs, including long-term care insurance, a deferred compensation retirement savings plan, and member education services.

Introduction

The overall role of the President of the Board of Administrationⁱ is to lead the Board in the conduct of Board business by managing the affairs of the Board and ensuring the integrity of the Board's processes. Consistent with this mandate, the Board President, on behalf of the Board, commissioned a Board Governance

project to examine significant areas of Board oversight, governance practices, accountability and decision-making, with the purpose of improving the effectiveness of the CalPERS Board of Administration. Each of these was addressed within the scope of the project.

Purpose of the Project

The purpose of this project was to improve the effectiveness of the CalPERS Board of Administration by improving oversight, clarifying accountability and improving decision-making. The project identified leading practices in six areas:

1. Principles for Effective Governance of Public Pension Funds
2. Board Powers Reserved and Delegation of Authority
3. Board Governance (Charters, Risk Oversight)
4. Board Self-Assessment
5. Board Self-Development
6. Selected Policies Governing Board Conduct

Options were then prepared for consideration by the Board and customized to CalPERS specific requirements. Interim reports were submitted to the CalPERS Board Governance Committee and full Board for discussion in July, August and September 2011. All approved recommendations are included in this final report which was completed in September 2011.

Project Process

Funston Advisory Services LLC (FAS), with the assistance of CalPERS fiduciary counsel, Reinhart Boerner Van Deuren s.c., collaborated with the CalPERS Board and executive staff over the time period March-September 2011 to develop a set of recommendations based upon an extensive set of activities and analyses, including:

- Review of numerous CalPERS and external documents;

- Review of the websites of the 50 largest U.S. public pension funds and 12 selected international pension funds, including an analysis of their governance structures;
- Completion of a governance benchmark survey and analysis with 16 leading large pension funds (domestic and international), including identification of leading practices in public pension fund governance;
- Extensive interviews with CalPERS Board members, executives, and others;
- Development of a survey of leading practices regarding independent reinsurance (both public and private sector);
- Identification of leading practices in Board self-assessment and Board self-development; and,
- Development of governance principles for public pension funds based upon leading practices.

The development of new governance principles and validation of leading governance practices for public pension funds were graciously assisted by a notable panel of independent governance experts (including Keith Ambachtsheer, Marco Becht, Peter Clapman, Stephen Davis, Keith Johnson, Jon Lukomnik, Ira Millstein, David Nierenberg, James Shinn, Therese Whitmarsh and Christianna Wood).ⁱⁱ

Actions Taken by the CalPERS Board of Administration

At the conclusion of the seven-month project, the Board of Administration approved a series of sweeping governance reforms in an effort to further strengthen accountability, efficiency, transparency and ethics at the nation's largest public pension fund. The changes provide a framework for supporting new policies and practices to improve the effectiveness of the 13-member Board, its committees and governance processes. The extensive reforms

adopted by the Board are described below and organized into ten topical areas.

1. Principles for Effective Governance of Public Pension Funds

Six new CalPERS governance principles were approved by the Board to provide a framework for the development of supporting policies and practices. These policies and practices should, in turn, help drive the achievement of goals, such as financial soundness. The principles also provide a framework for evaluating the effectiveness of the Board and enabling CalPERS to determine its current capabilities. The CalPERS Principles for Effective Public Pension Fund Governance are:

- i. Effective and Capable Fiduciaries.** Effectiveness is the super-ordinate principle for fund trustees to fulfill their fiduciary responsibilities to the plan's beneficiaries and participants. These fiduciary responsibilities and the nature of CalPERS business must be thoroughly understood. In turn, the Board must understand its role in successfully conducting that business and have passion for such success.

Capability, the corollary of effectiveness, requires competent Board members and executives who are able to balance short- and long-term objectives and develop and oversee the implementation of strategies for achieving intended outcomes.
- ii. Ethical Leaders.** As ethical leaders, the Board and executive team share values about what is important and work together with mutual respect in a constructive partnership. Together, the Board and executives set the tone at the top that permeates the organization.
- iii. Open and Accountable to Our Stakeholders.** The Board and executives are appropriately open in the way key decisions are made and publicly disclosed. Governance rules are clear and disclosed. The Board has access to the right expertise

and data free from undue influence. The Board and executives are both accountable to stakeholders for their performance.

- iv. **Risk Intelligent and Insightful in Decisions.** The Board approves the risk preferences and tolerances of the fund, and ensures the enterprise is prepared for low-probability, high impact risks and long-term sustainability. An effective enterprise risk management framework is used to consistently monitor and report aggregated risk exposures and the effectiveness of mitigation and control. The organization is willing to innovate and take calculated risks and innovate in the long-term best interests of the beneficiaries and participants.
- v. **Long-Term View of the Needs of Beneficiaries and System Participants.** The Board is actively engaged in establishing the long-term direction of the organization. It adopts a long-term, sustainable view toward, for example, financial soundness and effective retirement and health care solutions for members and employers. The Board integrates short-term and long-term perspectives on both assets and liabilities. Strategic choices are consciously made based upon strategic analysis and long-term thinking, not just a planning and budgeting process.
- vi. **Continuous Learning and Adaptation to Changing Conditions.** The Board conducts a regular assessment of its performance and capabilities. It identifies the skills and capabilities required to fulfill its fiduciary roles and responsibilities and maintains an inventory of existing trustee skills and capabilities, as well as strengths, weaknesses, gaps and priority development needs.

Detailed descriptions of each principle are available and include guidance for Board members to consider in their day-to-day activities on behalf of CalPERS and its stakeholders.ⁱⁱⁱ

2. Role of the Board and Committees

Four actions were taken to emphasize the fiduciary responsibility of Board members, their commitment to governance improvements, and the value of a long-term perspective:

- Each Board member will sign a statement acknowledging fiduciary responsibilities in conjunction with fiduciary training and self-assessment processes;
- The Board President will present an annual report which reviews progress in implementing governance reforms and improvements to Board effectiveness;
- Every two years, an independent third party will assess Board performance; and,
- The Board will develop a long-term CEO succession planning process.

The Board will continue to further improve the effectiveness and efficiency of its governance processes by increasing their focus on important strategic issues and reducing the number and length of committee meetings and the amount of time devoted to Board matters. This will help minimize unnecessary Board involvement in operational matters.

3. Role of President and Vice President / Chairs and Vice-Chairs

CalPERS already has policies^{iv} defining the role of the Board President, Vice President, Committee Chairs and Committee Vice Chairs. These policies and guidelines were found to be appropriate, but were not being followed, either in part or in full. As a result, the Board reaffirmed their commitment to implementing them as part of its governance reforms. In addition to the above-mentioned roles, the Board approved three additional actions in this area:

- Evaluate policies and processes related to Board travel to promote improved compliance, controls and value received;

- Evaluate the best means to improve the Board committee briefing process; and,
- Develop a framework to hold all executives accountable for performance linked to the agreed organization strategy, performance metrics and compensation system.

4. Powers Reserved for the Board

The Board recognized the need to improve its strategic focus, its overall governance processes, and its oversight effectiveness. With these objectives, the governance project reviewed the fundamental responsibilities of the Board, including an analysis of existing powers reserved for the Board at CalPERS and at other public pension funds. As a result, eighty powers were identified to be reserved for the Board.^v Approximately 70 percent of these were included in existing CalPERS governance documents, and the others were newly-identified during the project.

The eighty powers reserved are characterized as one of four types of Board responsibility and authority:

- *Conduct*: the Board performs the tasks described. This includes, for example, “Conduct setting of the Board and committee agendas, linked to an annual planning calendar, by identifying, articulating, prioritizing and scheduling matters and reports the Board will regularly address.”
- *Set*: the Board is actively engaged in developing the strategies and plans for the delegated activities and has final approval authority including, for example, the mission and vision of CalPERS, legislative priorities, and health care strategy.
- *Approve*: the Board has final decision authority on delegated activities. The Board retains approval authority for a wide range of decisions where the CalPERS staff develops recommendations, including, for example, strategic asset allocation,

organization performance metrics, contracting policies, and actuarial policies.

- *Oversee*: the Board requires adequate information to watch over, scrutinize, and provide direction and support, as appropriate (as distinct from close supervision and day-to-day management), on delegated activities. Although the Board of Administration has oversight for the entire organization, the powers reserved identify those oversight activities which are critical to the success of the organization and as such require that the Board be sufficiently informed to oversee. Examples include stakeholder relations, operations and cost effectiveness, cost and quality of the health care program and financial soundness.

Fifteen powers reserved will remain the responsibility of the full Board and the other sixty-five were aligned with the Board committees for initial consideration.

5. Board Committee Structure

Two actions were approved to improve how Board committees operate:

- Ensure the process for nominating and electing committee chairs and vice chairs is transparent and well understood; and,
- Adopt a policy to review committee delegations annually and update as needed.

In addition, the Board approved a restructuring of the committees to further improve operational effectiveness and interaction with the full Board and with the CalPERS executive:

- Governance items were moved out of the Benefits and Program Administration Committee (BPAC) into the Board Governance Committee and administrative items were moved out of BPAC and into the Finance Committee (renamed Finance and Administration Committee);

- The number of committees was reduced by consolidating the Health Benefits Committee and the remaining elements of BPAC into a new Pension and Health Benefits Committee; and,
- The Finance Committee and Risk Management Committee responsibilities were reconfigured to improve independent reassurance by consolidating all reassurance activities into a renamed Risk and Audit Committee.

6. Delegations to Executives and Board Reporting Relationships

The CalPERS Board made a fundamental change in the executive reporting structure to the Board in order to improve executive accountability and clarify leadership authority:

- The Board approved a motion to adopt a reporting structure with two direct reports to the Board, the CEO and the CIO (versus the previous four direct reports).

In addition, a series of other actions and policies were adopted to improve the effectiveness of Board-executive interaction and executive accountability, increase the level of mutual trust, improve independent reassurance and risk intelligence, and minimize the likelihood of undue influence:

- The Board will evaluate direct report performance and compensation based on the agreed-upon strategy, performance outcomes and metrics, not just activities;
- If the Board is not satisfied with the performance of its direct report(s), it will discipline or replace the executive(s) but will not get involved in day-to-day operations;
- The direct report(s) are responsible for providing reasonable assurance to the Board that there are capable people, processes and systems in place to achieve agreed-upon outcomes while managing

related risks so that they are within CalPERS established risk appetite;

- The Board will have ready access to all executives, such access to be coordinated by the CEO;
- The Board direct reports will have the primary authority and responsibility for the hiring, evaluation, compensation and termination of their direct reports;
- The Chief Investment Officer will retain investment autonomy and decision authority over hiring, evaluation, compensation and firing of Investment Office personnel;
- Executives (to the level of senior portfolio managers) will be required to certify in writing, at least annually, that they have been free from undue influence (i.e., when a person of higher authority exerts an influence that deprives another of his/her independent judgment) by any individual Board member, executive or third party; and,
- The Board and/or its committees will establish a schedule of closed session meetings with selected executives, i.e., those making frequent reports to the Board or significant investment decisions.

7. Setting the Board Agenda and Improving Reporting to the Board

Opportunities were identified to significantly improve control of the Board and committee agendas and meetings, with a focus on making the highest and best use of the Board's time and improving outcomes for CalPERS. The actions taken by the Board to improve the setting of the Board agenda include:

- Setting the Board agenda will be tied directly to the annual CalPERS planning calendar;
- The Board agenda will be tied directly to the Board's approval and oversight

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responsibilities and related outcomes (this is linked directly to the newly-defined powers reserved for the Board and the new committee structure);

- The Board President and the CEO, in consultation with the Board Committee Chairs, will actively engage the Board in setting the strategic agenda, and review and make adjustments quarterly;
- The CEO will engage the Board in collaboratively developing CalPERS strategy; and,
- The Board, working with the executive staff, will develop and adopt a concise, consistent framework for agenda decision items which includes, for example, the recommendation, description and analysis of alternatives considered, pros and cons of the recommendation, risks of action and inaction, long-term implications, and costs and benefits. This framework will to be used by the Board and committees for all agenda decision items.

In addition to improving the setting of the Board agenda, the project also identified extensive opportunities to significantly improve the information reporting process from the executive to the Board. The following actions have been approved by the Board to improve the efficiency, effectiveness and insightfulness of Board decision-making, thereby leading to better outcomes and increasing the likelihood of CalPERS reaching its goals:

- The Board will maintain a list of significant topics/issues which are of interest to the full Board but are delegated for deliberation and recommendation to one of the Board committees (e.g., pension soundness, organization strategy). Each committee will report on its discussions and deliberations of significant issues and present its recommendations to the full Board to ensure that each member is adequately informed. At the same time, each Board member has a responsibility to stay

apprised of key issues being addressed by the various committees;

- The Board and each committee will review all current information reports to determine those which are statutorily required and those which may be streamlined or removed;
- The Board will define its information requirements, the thresholds that trigger Board attention for each topic, and the frequency of standard reports;
- The CEO will be responsible for keeping the Board appropriately informed and escalating issues on a timely basis;
- The Board will make use of consent agendas to bundle items which do not require debate into a single voting package to expedite approval of routine matters;
- The President and CEO will be responsible for managing the effective and efficient flow of information to the Board without being overly detailed;
- The CEO will assign a specific senior executive to coordinate with each committee and collaboratively develop the annual agenda proposals, and the effective and efficient flow of pertinent information will be a compensable performance goal for the responsible executive;
- Each committee will maintain a standing set of questions pertinent to recurring decisions or oversight for that committee. This will typically include questions related to the potential outcomes of a decision and their impact on the goals of CalPERS (e.g., what is the long-term impact of this decision on our members? How does this decision mitigate risk?);
- The Board will adopt a policy whereby committee chairs are responsible for receiving and prioritizing (based upon established policies) ad hoc requests for new reports and analyses, taking into account the effect on staff time and

resources required to produce such reports and analyses;

- A sunset review of all reports will be conducted at appropriate intervals to determine their continuing utility; and,
- A Board portal will be implemented to facilitate effective decision making and best use of Board member time.

8. Board Self-Assessment Process

Although CalPERS has had a self-assessment policy and has performed annual self-assessments, the project confirmed that the existing process did not include a number of leading practices and did not meet the needs of the Board. In order to significantly improve the effectiveness of the self-assessment process, the Board adopted the following new policies:

- The Board will implement a new self-assessment process which assesses the whole Board, the president and vice president, individual members, committees, and committee chairs and vice chairs, and includes multiple bases for evaluation:
 - Principles;
 - Responsibility and authority;
 - Process; and,
 - Outcomes.
- One or more techniques will be utilized for obtaining self-assessment feedback:
 - Expert third party facilitator to lead or co-lead (with the Board President) the self-assessment process;
 - Get feedback from external key stakeholders on Board performance;
 - Obtain a third party evaluation of the Board's performance; and,
 - Include peer-to-peer and upward evaluations (360°) from staff.

9. Board Self-Development Process

The goal of a Board self-development program is to improve the effectiveness and efficiency of the Board. The traditional CalPERS education program has focused primarily on the legal process and structure, which is necessary, but not sufficient, for improved Board effectiveness.

The project identified opportunities for programs which focus on team dynamics, Board culture and soft skills such as collaboration and group problem solving, as well as additional education in select technical areas such as investing, insurance, actuarial standards, and technology.

The Board approved the following new policies to improve the effectiveness of its self-development efforts:

- An annual continuing education plan and budget will be established;
- Leadership education will be provided to all Board members on the role of the Board vis-à-vis management and the role of the chairs and vice-chairs in the effective management of Board and staff time;
- A profile of the skills and attributes desired for the Board overall and for each committee chair and member will be developed, and Board development programs will be designed consistent with the desired attributes and skills;
- Certain Board self-development activities will be tied directly to topics contained in the decision-making agenda;
- An educational element will be built into each Board meeting, or if not each meeting, in a regular cadence; and,
- The Board will evaluate public disclosure of the annual development activities completed by each member.

10. Selected Policies Governing Board Conduct

Endnotes

Benchmarking identified a confidentiality policy as a leading practice to help preserve the integrity of the Board's decision-making process and protect confidential information. Consequently, the Board has adopted the following:

- For matters which legitimately should be kept confidential (personnel matters, contract negotiations, sensitive investment information), the Board will adopt a confidentiality policy which:
 - Provides for disciplinary action if violated;
 - Applies to Board members, staff, and external service providers; and,
 - Prohibits use of confidential information for personal gain or for the benefit of outside interests.

ⁱ See CalPERS Board of Administration Statement of Governance Principles, December 2009

ⁱⁱ See Appendix M for biographies of all Expert Panel members

ⁱⁱⁱ See Appendix A for a full definition of each principle

^{iv} See CalPERS Board of Administration Statement of Governance Principles, December 2009

^v See Appendix D for a full listing of Powers Reserved for the Board

The Board Governance Project

Many of the improvements contained in this landmark governance project are already underway. Some will take significant time and effort to fully implement. However, the CalPERS Board of Administration believes this program, in its entirety, represents a critical step in helping to ensure the public's trust in its decisions, actions and operations.

As indicated previously, the Board President will report annually on the Board's progress in improving its governance and on the results of this reform program. In addition, an expert, independent third party will be asked to review CalPERS governance biannually to ensure objective, informed feedback, support for continuing improvement, and full transparency with all stakeholders.